



Center for Social and Economic Research

Address: Sienkiewicza str.12, 00-010 Warsaw (Poland)
tel: (48 22) 622-66-27 or 828-61-33; fax (48 22) 828-60-69
E-mail: marek@case.com.pl (Warsaw); marek@hiid.kiev.ua (Kyiv)

Marek Dabrowski

The threat of inflation increase - a new challenge for Ukraine's monetary and fiscal policy

Inflation rate in Ukraine has seriously accelerated since November 1999. It actually reached 14.4% in the first five months of the year 2000. There is a certain threat that the forecast annual inflation will be substantially «overfullfilled» in December and may be close to 30%. Apart from being a threat on the NBU and the Government's reputation this could enhance inflationary expectations and ruin the confidence into Hryvnya.

Many economists and politicians are not anxious about the increasing inflation indicators, attributing it to the effect of one-shot extraordinary factors. Considered are the administratively implemented price increases for housing and utilities as well as for basic food products. Earlier, i.e. during the election campaign, these prices were artificially curbed through administrative methods at the regional and local levels.

Although this diagnosis is truthful, it only shows a fraction of the whole picture. Apart from the above mentioned price shocks the typical monetary factor has played a crucial part (i.e. fast rate of the money base expansion and even faster rate of increase in the money supply). The process began in May 1999 and after short-term slowdowns in November 1999 and January 2000 is still in place. With annual inflation of 19.2 % in 1999, the monetary base grew by 39 % and the monetary aggregate M3 grew by 40.5 %. It should be underscored that these rates were negative during the first quarter of 1999.

During first four months of current year the growth rates of monetary base and money supply increased respectively by 11.8 % and 13.7 %, with the inflation of 12.1 % for the same period. Particularly fast growth of the money aggregates was noticed in April. Given that administrative price increases for housing and utilities (and gradual departure from the practice of administrative restraint of food prices at the regional level) provoked the increase in consumer prices, it was the monetary policy, which constituted favorable ground for such a growth. Moreover, it has accommodated the consequences of administrative impulse. What is even worse, it gives space for further increase in prices, especially when the new shocks are coming.

Remonetization of Ukraine's economy that followed the currency crises in 1998 ensured against the inflation consequences at the beginning of fast growth in money aggregates in 1999. However, the failure to eliminate the fundamental causes of the lack of confidence into Hryvnya exhausted this resource. The following should be mentioned as these causes: threat of default and Hryvnya's further devaluation, fragile banking system, unfavorable investment

climate, continuing budget crises and political instability. Inflationary processes may rise and limited remonetization may be substituted with yet another recourse to dollar if the current relatively stable Hryvnya rate is not maintained.

The NBU's interventions at the currency market are to be mentioned first among the factors contributing to the expansion of monetary base. They are justified by the NBU's need to recover its net foreign assets. However, to limit the potential inflationary consequences of increase in the currency reserves (and the monetary base respectively) the NBU should perform sterilization, i.e. either reduce its net domestic assets or reduce the monetary multiplier.

Let us briefly discuss the potential methods and instruments for sterilization:

1. Reduction of the net credit to the government through government's redemption of a portion of its debt to the NBU. This form would be the healthiest for Ukraine's economy. However, it requires either stable budget surplus or substitution of the NBU lending with privatization receipts or borrowing via T-bills/Eurobonds etc. All these measures are currently not feasible. At the same time, while working out the budget draft for year 2001 it is necessary to foresee the potential for budget surplus achievement (according to the IMF methodology) along with increase in the privatization revenues directed to clear the government's arrears to the National Bank.
2. Reduction of the net credits to commercial banks including the open market operations. Normally, Central Banks use outright sale or reverse repo operations. After the 1998 crisis, the reliance on T-bills (OVDP) in order to absorb the banking sector liquidity is rather difficult due to the lack of confidence into these instruments. The remaining option for the NBU is to issue its own deposit certificates. This option should be used more extensively. However, quasi-fiscal costs of the open market operations (decrease in the NBU profits and transfers to the budget) restrict the scale of such operations.
3. The NBU may also try to reduce the volumes of refinancing and lombard credit to commercial banks. However, the policy of gradual decrease of rates (three times during this year) stands on the way for such an effort.
4. Finally, the NBU may try to reduce the money multiplier through increase in the reserve requirements. This measure shifts the sterilization costs on the banks and as such is not popular in the banking sector. However, this is the only instrument at the NBU's disposal during following months, which may potentially yield fast results. Unfortunately, the NBU has so far been moving into the opposite direction reducing the reserve requirements three times.

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